Internal Revenue Service

memorandum

INTL-165-91
Br3:CSShein

date: OCT 23 1991

to: Larry Vining
International Examiner

from: Chief, Branch 3
Office of Associate Chief Counsel (International)

subject: Foreign Oil and Gas Extraction Income - section 907(c)(4)

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You have requested informal counsel assistance in connection with an issue arising in an audit of [redacted], which is engaged in oil and gas exploration outside of the United States and its possessions. As we understand the facts, the corporation is a member of an affiliated group filing a consolidated U.S. income tax return. Prior to 1982, the group conducted oil and gas exploration activities abroad through a U.S. subsidiary. As a result of a change to § 907(c)(4) of the Internal Revenue Code (the "Code")[1] in 1982, the group transferred its oil and gas explorations to controlled foreign corporations (CFCs). The examiner would like to recharacterize income of the CFCs to prevent the taxpayer from avoiding the application of § 907(c)(4) as amended in 1982.

Section 907 of the Code imposes a limitation on the allowable § 901 foreign tax credit for taxes imposed on foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI). The § 907 limitation applies in addition to the § 904 limitations. FOGEI is defined as taxable income derived outside the United States and its possessions from the extraction of minerals from oil and gas wells and the sale of assets used in the extraction business. Section 907(c)(1). FORI includes foreign source taxable income from the processing, transportation, distribution or sale or other related activities with respect to oil and gas

[1] Unless otherwise stated, all Code references are to the Internal Revenue Code of 1954 as in effect for taxable years beginning after December 31, 1982.

primary products. Section 907(c)(2). The limitation for FOGEI taxes (for corporations) is the amount of FOGEI multiplied by the highest U.S. corporate tax rate. Taxes paid in excess of this amount are neither deductible nor creditable, but may be carried over under the rules of § 907(c)(4) (discussed below). The FORI tax limitation provides that FORI taxes are not creditable to the extent that those taxes materially exceed the taxes that the foreign government imposes on non-oil related income.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248) ("TEFRA"), § 907 included a special rule for computing FOGEI if extraction losses were incurred. Under that rule, the "per-country extraction loss rule" of § 907(c)(4), if extraction activities and the sales of extraction assets in any country resulted in a loss for any year, the loss from that country was not taken into account in computing worldwide FOGEI for the year. The losses were, however, taken into account in computing worldwide FORI (which, for pre-TEFRA years, included FOGEI) for the year. The effect of the per-country loss rule was to increase the amount of creditable FOGEI taxes for the year (because FOGEI was not reduced by the loss) and to allow a company to use what would have been excess FOGEI credits to offset generally lower taxed other FORI for the year because FOGEI taxes paid to the loss country became FORI taxes.[2]

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[2] The legislative history of TEFRA provides an example of the potential for abuse under the per-country loss extraction loss rule:

> [I]f a company's extraction activities generated $300 of income in country A on which it paid $138 of foreign income tax and a $100 loss in country B, it would have net income of $200 from those foreign extraction activities on which it would pay $92 of U.S. tax (at a 46-percent rate) before the foreign tax credit. However, because the $100 loss would not be taken into account in computing the 46-percent extraction limitation under present law [the per-country extraction loss rule], the company would be entitled to claim oil tax credit of $138 (46-percent of $300)--using $92 in credits against the U.S. tax on the net extraction income and the $46 excess credits against other oil-related income. The use of $46 of extraction tax credits to reduce U.S. tax on other income is generated only as a result of the per-country loss rule.

S. Rept. 97-494, Vol. 1, 97th Cong., 2d Sess. 147 (1982).

Congress decided that it was inappropriate to allow taxpayers to reduce U.S. tax on other income by using oil and gas extraction credits that would have been unavailable without the per-country loss rule. Thus, in 1982, Congress repealed the per-country loss rule. A taxpayer's net extraction loss from any country is now taken into account in computing worldwide FOGEI for the year. If a taxpayer has an "overall foreign extraction loss" for the year, the loss will reduce non-extraction income for the year but will be recaptured in subsequent years in which the taxpayer has extraction income. All taxes attributable to the loss remain FOGEI taxes. If a taxpayer is part of an affiliated group filing a consolidated income tax return, the group's overall foreign extraction loss is determined by netting foreign oil and gas extraction income and losses of all members of the group. In cases where the taxpayer realizes an overall foreign loss, part of which is attributable to a foreign extraction loss, both the overall foreign loss recapture rules (§ 904(f)) and the foreign extraction loss recapture rule apply. See § 904(c)(4).

In response to the repeal of the per-country loss rule, many taxpayers that conducted oil and gas exploration and extraction operations abroad through U.S. subsidiaries transferred their exploration phase operations to CFCs.[3] During the exploration phase, oil and gas operations are likely to generate losses. The effect of transferring them abroad was to remove the losses from the consolidated group. In addition, if the exploration was unsuccessful, the loss would offset only the CFC's earnings and profits and would not appear on the affiliated group's financial statements. Finally, by reducing the CFC's earnings and profits, the exploration losses also would reduce the amount the U.S. parent would have to include in income under subpart F of the Code. See § 951.

In the instant case, the taxpayer apparently transferred its oil and gas exploration operations to second-tier CFCs. The first-tier foreign corporations were captive insurance companies or other "tax haven" corporations with significant amounts of excess capital.

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[3] As noted infra, § 367(a) applies to the taxpayer's transfer of its oil and gas exploration activities from a domestic to a foreign corporation.

The examiner argues that the sole purpose of the transfers was to avoid the repeal of the per-country loss rule and consequently, that we should be able to recharacterize any distribution or subpart F inclusion from the CFC to recognize the FOGEI loss. This result, however, requires a finding that there was no business purpose for the transfers, and we do not think that is the case. The taxpayer's segregation of a risky activity to prevent a potential loss from adversely affecting the entire group, and its transfer to a nonincludible corporation to prevent losses from appearing on the group's financial statements are valid non-tax reasons for transferring oil and gas exploration activities to a CFC.

Congress recently provided the Service with regulatory authority to address the abuse caused by affiliated groups "deconsolidating" to avoid the § 904 separate foreign tax credit limitation. Thus, we may issue regulations that provide for resourcing of income if an affiliated group removes a loss corporation from its consolidated return group by inserting a foreign corporation in the chain of ownership. This section is not effective, however, until we issue regulations. Further, as those regulations are currently being drafted, they will not address the instant case because it does not involve deconsolidation. Adding a CFC at the end of a chain of ownership is not the same as inserting a CFC between two U.S. corporations to remove one of them from an affiliated group.

[redacted]'s decision to move its oil exploration activities overseas to circumvent the repeal of the per-country loss rule was not without tax consequences. Section 367(a) would apply to the transfer of assets abroad. See § 1.367(a)-4T(e), Temporary Income Tax Regulations. Further, if the foreign exploration activities generated losses when conducted as branches of a U.S. subsidiary, [redacted] should have recaptured these losses when it transferred the branch operations to the CFCs. See § 1.367(a)-6T of the temporary regulations.[4]

[4] For a general discussion of branch loss recapture, see Rev. Rul. 78-201, 1978-1 C.B. 91 (published prior to the temporary regualtions under § 367(a)).

The examiner has stated that he plans to send additional information. We have not received this information and are closing the case. If we receive any further information, we will reopen the case and consider it at that time. If you have any questions, please contact Caren S. Shein at (202) 566-3452.

Sincerely yours,

Carol Doran Klein